

# ANALYSIS OF AMENDED BILL

## Franchise Tax Board

Author: Alquist Analyst: Marion Mann DeJong Bill Number: AB 1218  
Related Bills: \_\_\_\_\_ Telephone: (916) 845-6979 Amended Date: 07/06/98  
Attorney: Doug Bramhall Sponsor: \_\_\_\_\_

**SUBJECT:** B&CT Deduction/Interest Expense/Insurance Companies

DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended \_\_\_\_\_.

☒ AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended \_\_\_\_\_.

FURTHER AMENDMENTS NECESSARY.

DEPARTMENT POSITION CHANGED TO \_\_\_\_\_.

☒ REMAINDER OF PREVIOUS ANALYSIS OF BILL AS AMENDED February 26, 1998, STILL APPLIES.

OTHER - See comments below.

### SUMMARY OF BILL

This bill would do the following.

1. Allow corporations to deduct interest expense attributable to dividends that are received from an insurance company subsidiary and are excluded from income. This bill would further specify that Section 24425 (which denies a deduction for expenses relating to the production of income that is not included in the measure of California tax) would not apply to expenses related to deductible dividends received from insurance companies.
2. Remove the commercial domicile restriction from Section 24410, thereby permitting all corporations, regardless of commercial domicile, to deduct dividends received from an insurance company subsidiary.

### SUMMARY OF AMENDMENT

The July 6, 1998, amendments (1) added a provision to remove the commercial domicile restriction from Section 24410; and (2) replaced language that stated that the changes made by the bill were declarative of existing law with language that states the bill is not intended to be construed to have any effect on the interpretation or application of Section 24344, 24410 or 24425 prior to the effective date of the bill.

The department's analysis of the bill as amended February 26, 1998, discussed only the provision relating to deductible dividends received from insurance companies. Modifications to the prior analysis are discussed below. In addition, a full analysis of the provision to remove the commercial domicile restriction from Section 24410 is provided. The Fiscal Impact from the department's prior analysis is replaced with the following.

#### Board Position:

<input checked="" type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP
<input type="checkbox"/> SA	<input type="checkbox"/> O	<input type="checkbox"/> NAR
<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input type="checkbox"/> PENDING

#### Department Director

Date

Gerald H. Goldberg

7/31/98

## FISCAL IMPACT

### Departmental Costs

This bill would not significantly impact the department's costs.

### Tax Revenue Estimate

This bill would result in unknown annual revenue losses (beginning January 1, 1998) that cannot be quantified due to data limitations.

### Tax Revenue Discussion

Sufficient data do not exist to estimate the magnitude of losses resulting from removing the commercial domicile restriction from Section 24410. Even without this bill, revenue losses are likely as the result of cases testing the constitutionality of the current statute under which only commercially domiciled corporations are allowed the partial dividend deduction.

Further, it is unclear whether and to what extent revenue losses would result from the removal of the expense deduction limitation for insurance company dividends since it is unclear whether the taxpayer or the department would prevail in a case on this issue.

## BOARD POSITION

Support.

At its May 28, 1998, meeting the Franchise Tax Board voted 2-0 to support this bill as amended February 26, 1998, with the representative from Department of Finance absent. This reaffirmed the support position taken by the Board at its July 21, 1997, meeting on the June 30, 1997, version of the bill.

The Franchise Tax Board voted at its January 12, 1998, meeting to sponsor language to remove the commercial domicile restriction from Section 24410.

### 1. Deductible Dividends Received From Insurance Companies

The Effective Date and discussion of the bill in Specific Findings from the department's prior analysis are replaced with the following. The remainder of the analysis of the bill as amended February 26, 1998, still applies.

### EFFECTIVE DATE

As a tax levy this bill would become effective immediately upon enactment and apply to income years beginning on or after January 1, 1998.

### SPECIFIC FINDINGS

**This provision** would allow corporations to deduct interest expense attributable to dividends received from an insurance company subsidiary which are excluded from income (pursuant to the dividends received deduction of Section 24410).

**This provision** would further specify that Section 24425 would not apply to expenses related to deductible dividends that a corporation received from an insurance company subsidiary.

## **2. Commercial Domicile Restriction**

### **EFFECTIVE DATE**

As a tax levy this bill would become effective immediately upon enactment and apply to income years beginning on or after January 1, 1998.

### **SPECIFIC FINDINGS**

**Federal law** allows a deduction from gross income for dividends received from a domestic corporation that is subject to income tax. This deduction is limited by stock ownership. One hundred percent of the deduction is allowed when received from a corporation that is a member of the same affiliated group (generally, 80% or more common ownership); 80% of the deduction is allowed when received from a corporation which is 20% or more, but less than 80% owned; and 70% of the deduction is allowed when received from a corporation less than 20% owned. The percentage owned refers to the percentage of stock, by vote and value, owned by the recipient corporation. Preferred stock is not considered in determining the percentage of stock owned. In addition, 100% of the deduction is allowed for dividends received by a small business investment company.

The total dividend deduction cannot exceed 70% (80% in the case of a 20% owned corporation) of the recipient corporation's recomputed taxable income. When recomputing taxable income, any net operating loss deduction, dividend received deduction, capital loss carryback and certain special deductions are not allowed.

**Current Bank and Corporation Tax Law (B&CTL)** provides for the use of an apportionment formula when assigning *business income* of multistate and multinational corporations to California for tax purposes. For most corporations, this formula is the average of the factors of property, payroll and double-weighted sales applied against worldwide income. Each factor is the ratio of in-state activity to worldwide activity. *Nonbusiness income* is generally allocated to the taxpayer's commercial domicile.

**California Regulation Section 25120(c)(4)** applies transactional/functional tests to determine the classification of dividend income as business or nonbusiness income. Under these tests, dividends are *business income* when (1) the stock was acquired in the regular course of the taxpayer's trade or business operations, or (2) the purpose for acquiring and holding the stock is related to or incidental to the trade or business operations.

Thus, dividends are *business income* when the stock from which those dividends are derived is held in the ordinary course of business, such as by a stockbroker. Generally, dividends will also be *business income* if they are derived from stock held as current assets or excess working capital. More recently, dividends have been considered to be *business income* when the stock is held for a purpose which furthers the unitary business operations, such as when stock of a supplier is held in order to ensure a steady source of raw materials (Appeal of Standard Oil Company of California, Cal. St. Bd. of Equal., March 2, 1983).

Generally, dividends are *nonbusiness income* when the stock is held as an investment unrelated to the taxpayer's trade or business activities. **The B&CTL** (Section 25126) provides that *nonbusiness* dividend income is allocated to the taxpayer's commercial domicile.

**The B&CTL** (Section 24402) excludes from taxable income a portion of dividends received in taxable years beginning after 1989 that are paid out of income that was subject to either the franchise tax, the alternative minimum tax or the corporation income tax in the hands of the paying corporation. The intent of this law is to avoid double taxation of corporate income at the corporate level. The exclusion is in the form of a deduction from gross income. For the recipient corporation to claim such a deduction, the paying corporation must have had income from sources in California that required the filing of a California income or franchise tax return. The Franchise Tax Board makes a computation each year, after the returns are filed, to determine the percentage of dividends paid during the year which are deductible by recipient corporations. The deduction is further limited based on the recipient's percentage ownership in the distributing corporation, similar to the federal stock ownership rules.

**Under the B&CTL** (Section 24410), corporations *commercially domiciled in California* are permitted to deduct dividends received from an insurance company subsidiary operating in California and subject to the gross premiums tax, provided at least 80% of each class of stock of the insurance company is owned by the parent corporation. The deduction is based on the portion of the dividend attributable to California sources, determined by applying a special three-factor formula.

The rationale for Section 24410 is to provide a similar relief from double taxation as is provided to general corporations under the dividends received deduction of Section 24402. Section 24410 essentially determines the hypothetical income that would have been properly imposed on an insurance company if it were in fact subject to the franchise tax, and treats the gross premiums tax as having been imposed on that income.

When Section 24410 was enacted (Stats. 1968, Ch. 1379), essentially all dividends were thought to be nonbusiness income unless receipt of dividends was the taxpayer's principal trade or business (i.e., dealers in stocks and securities). This theory was based on pre-Uniform Division of Income for Tax Purposes Act (UDITPA) case law that held the source of the dividend income was the shares of stock and the situs of such stock was traditionally the commercial domicile of the investing corporation (Southern Pacific Co. v. McColgan, 68 Cal. App. 2d 48 (1945)). Earlier versions of California regulation Section 25120(c)(4) reflected this theory.

Subsequently, California case law held that dividends could be business income if the dividends met the transactional/functional tests implicit in Section 25120, and that the (former) FTB regulations were invalid because they were contrary to those statutory tests (Appeal of Standard Oil Company of California, Supra.). The Franchise Tax Board amended Regulation Section 25120(c)(4) to apply transactional/functional tests to determine the classification of dividend income as business or nonbusiness income.

Because dividends can be treated as business income, the commercial domicile restriction in Section 24410 operates as a preferential treatment only for California commercially domiciled corporations. Recent court decisions have found similar laws to be facially discriminatory against interstate commerce, without legitimate local purpose, and thus unconstitutional (e.g., Camps Newfound/Owatonna, Inc. v. Town of Harrison, Maine (1997) 520 U.S. 564, 137 L. Ed. 2d 852). Thus, it is likely that Section 24410 would be found unconstitutional as discriminatory against interstate commerce.

**Article III, Section 3.5 of the California Constitution** provides that an administrative agency does not have the power to declare a statute unenforceable, or refuse to enforce a statute on the basis that federal law or federal regulations prohibit the enforcement of such statute, unless an appellate court has made a determination that the enforcement of such statute is prohibited by federal law or federal regulations.

**This provision** would remove the commercial domicile restriction from Section 24410. Thus, all corporations, regardless of where commercially domiciled, would be permitted to deduct dividends received from an insurance company subsidiary.

#### Policy Considerations

There does not appear to be specific tax policy to support relief from double corporate taxation only for California domiciled holders of insurance stock. Further, the objective of Section 24410 appears to be the same as the objective of Section 24402: to provide relief from double taxation. The commercial domicile restriction of Section 24410 was probably included because, at the time of enactment, such dividends were generally thought to be nonbusiness income, allocated to commercial domicile. By removing the commercial domicile restriction from Section 24410, this bill would make the tax policy of Section 24410 consistent with Section 24402.

#### Implementation Considerations

Since the removal of the commercial domicile restriction from Section 24410 would apply only for years beginning on or after January 1, 1998, the department would be required by the state's Constitution to enforce the restriction for prior years unless and until an appellate court declares California law to be in violation of federal law. Implementation of this bill would occur during the department's normal annual system update.